

## **2015 Bench-Bar Retreat**

**October 30, 2015**

**Independence, Ohio**

### **Individual Chapter 11 Debtors: Best Practices**

#### **I. Pre-filing Considerations**

##### **A. Pre-Filing Diligence**

- Take time to know and understand your debtor.
  - What are their goals?
  - Why doesn't chapter 7 work?
  - Why doesn't chapter 13 work?
  - What facts will come out in bankruptcy that might not elsewhere?
  - Be ready to explain why creditors who are friends and family are treated just like the mortgage lender.
  - Remind debtor that, once bankruptcy is filed, "it's not all about them."
  - Remember importance of other professionals (*e.g.*, accountants, financial advisors).
  - Do sources exist for added value – (*e.g.*, new, substantial, money or money's worth, reasonably equivalent to the value or interest received) [See Exit Strategy - 1129(b)(2)(B)(ii).]
  - Educate the debtor as to the ongoing administrative costs included in a successful reorganization.
- Take time to know and understand creditor base.
  - What gave rise to the debts?
  - Are debts consumer or non-consumer?
  - What is the collateral base?
  - What is the nature of the creditors? Traditional banks, friends, family, others?
  - Is there a reasonable probability of confirming a plan?
- Protect good-faith finding.
  - If time permits, engage in meaningful, documented negotiations with creditors.
  - Test the water on would-be chapter 11 plan → preemptively identifying likely post-petition issues.

## **B. Timing**

- If possible, time filing such that “current monthly income” is low enough to satisfy means test in the event you seek to convert to chapter 7.
- Consider implications of executory contracts and leases.
- Remember that timing may influence finding of good faith in the filing itself.

## **C. Develop Exit Strategy Before Filing**

- Know what your chapter 11 plan will look like before you file.
- “Test” would-be chapter 11 plan during pre-petition creditor negotiations  
→ preemptively identifying likely post-petition issues.
- Evaluate alternatives if you cannot confirm plan.
- Remember two key Bankruptcy Code Sections:
  - Section 1115 (post-petition earnings/estate property); and
  - Section 1129(b)(2)(B)(ii) (absolute priority rule);

## **D. Managing the Client/Others Close to Client Throughout**

- Remember you are dealing directly with a person.
- Remember you may be dealing with a family.
- Constant communication key.
- Renew efforts to communicate in “lay terms.”
- Communicate in many media.

# **II. Operating in Chapter 11**

## **A. Property of the Estate**

- Sections 541 and 1115

## **B. Cash Collateral/Cash Management**

- Who, if anybody, has an interest in it?
- Section 363: seek authority to use.

## **C. Budget/Budgeting**

- Need to identify and include accountant or responsible party (See Pre-filing diligence)
- Remember lack of foresight and budget is probably a component as to why the Debtor is seeking your assistance
- Cash Collateral Budgets

- 90-day budget
- Projected Plan Budget

#### **D. Section 341 Meeting of Creditors**

- Client should thoroughly understand Schedules and SOFAs.
- Preparation is critical.

#### **E. Involvement of the U.S. Trustee**

- Many times no committee → enhanced role of U.S. Trustee

#### **F. Other Considerations**

- Litigation elsewhere?
- Maintaining insurance
- Operating Reports

### **III. The Plan**

#### **A. Unique Challenges in Individual Chapter 11s**

- Property of the Estate/Post-Petition Earnings

#### **Section 541 (Property of the Estate):**

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is—

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

(3) Any interest in property that the trustee recovers under section 329(b), 363(n), 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) Any interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with the debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as a beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

### **Section 1115 (Property of the Estate):**

(a) In a case in which the debtor is an individual, property of the estate includes, *in addition to the property specified in section 541—*

(1) all property of the kind specified in section 541 that the debtor acquires *after the commencement of the case* but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first; and

(2) earnings from services performed by the debtor *after the commencement of the case* but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.

(b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

- Confirmation and “Cram-Down”

### **Section 1129 (Cram-Down):**

(b) (1) Notwithstanding section 510 (a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

\* \* \*

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.

- *Ice House Am., LLC v. Cardin*, 751 F.3d 734, 738 (6th Cir. 2014) (applying absolute priority rule to individual Chapter 11 debtors).

## **B. Strategies for Achieving Plan Confirmation**

- Object early to questionable claims held by aggressive creditors.
- Present better plan than chapter 7 liquidation. Don't ignore the reality that the Debtor has probably already presented failed proposals to creditors.
- Present better plan than piecemeal, non-bankruptcy collection.
- Make reasonable, readily-documented/provable assumptions.
- Engage in dialogue with creditors.
- Remind debtor again that, in chapter 11, "it's not all about them."
- Seek third-party opinions on plans (*e.g.*, financial advisors).
- Seek third-party support of plans (*e.g.*, creditor committee and/or U.S. Trustee).
- Plan mediation.
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## **C. Discharge—When and How Obtained**

- Section 1141(d)(5)(A) completion of plan payments (rather than plan confirmation) discharges an individual debtor.
- Fed. R. Bankr. P. 2015(a)(5) - Debtor responsible for providing reports of post-confirmation disbursements and for paying all additional fees that accrue.
- Think about Sections 1129(a)(15)(B) and 1141(d)(5)(B)(i) to reduce the term and provide projected disposable income through post-confirmation borrowing from friends or family.
- Don't forget post-petition credit counseling, which may be required under Sections 1141(d)(3) (in case of a liquidating plan) and 727(a)(11).

## IV. If the Plan Fails

### A. Conversion

#### Section 1112(a)

(a) The debtor may convert a case under this chapter to a case under chapter 7 of this title unless—

- (1) the debtor is not a debtor in possession;
- (2) the case originally was commenced as an involuntary case under this chapter; or
- (3) the case was converted to a case under this chapter other than on the debtor's request.

#### 1. Absolute Right to Convert

It is widely recognized that Debtor has an absolute right to convert his case to one under Chapter 7 under these circumstances. *See, e.g., In re Texas Extrusion Corp.*, 844 F.2d 1142, 1161 (5th Cir. 1988) (“A debtor has the absolute right to convert his or her Chapter 11 case to a Chapter 7 case [pursuant to] Section 1112(a) [.]”); *In re Dieckhaus Stationers of King of Prussia, Inc.*, 73 B.R. 969, 971 (Bankr. E.D. Pa. 1987) (Section 1112(a) “by its terms[ ] gives the debtor an absolute right to convert unless the case is governed by one of the enumerated exceptions.”) and *In re Noonan*, 17 B.R. 793, 795 (Bankr. S.D.N.Y. 1982) (acknowledging that where debtor perceived “the effusion of time, energy and money he would need to battle [a creditor in Chapter 11], [debtor] exercised his absolute right to convert his chapter 11 to a chapter 7 case.”). This is unsurprising because Section 1112(a)(1) is clear on its face and, as a result, its express language is conclusive of its meaning. *See Lamie v. U.S. Trustee*, 540 U.S. 526, 534 (2004) (citing *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000)). Debtor's absolute right to convert his case nevertheless is *confirmed* by the legislative history of Section 1112, providing: “This section brings together all of the conversion and dismissal rules for Chapter 11 cases. Subsection (a) gives the debtor an absolute right to convert a voluntarily commenced chapter 11 case in which the debtor remains in possession to a liquidation case.” *In re Schuler*, 119 B.R. 191, 192 (Bankr. W.D. Mo. 1990) (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 405 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 117 (1978)); *see also In re Dieckhaus*, 73 B.R. at 971 (“The legislative history [of Section 1112] confirms Congress' intent to give debtors an absolute right to convert from chapter 11 to chapter 7.”).

#### 2. Potential Limitations on Conversion—Where Debtor Ineligible for Chapter 7 Relief

##### *Bad Faith, Gross Inequity, Abuse of Bankruptcy Process*

Some courts have denied conversion based on bad faith, gross inequity, or abuse of the bankruptcy process. *See, e.g., Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 374 (2007) (denying conversion from Chapter 7 to Chapter 13 where the debtor filed a petition in bad faith and concealed significant assets.). *See also In re Results Systems Corp.*, 395 B.R. 1 (E.D. Mich. 2008); *Monroe Bank & Trust v. Pinnock*, 349 B.R. 493 (E.D. Mich. 2006); *In re Modern Metal Prods., Co.*, 422 B.R. 118 (Bankr. N.D. Ill. 2009); and *In re Adler*, 329 B.R. 406 (S.D.N.Y. 2005). Many of these same courts still give significant deference to a debtor's choice of chapter under

which to proceed. *See, e.g., Modern Metal Prods.*, 422 B.R. at 124. (“In Section 1112(a), as well as other sections, Congress has granted a clear right to debtors to decide which chapter their case should proceed under, and the Court is loath to overturn that choice without a strong showing of an abuse of the system or clear detriment to parties in interest.”)

*Where Chapter 7 Would be Subject to Dismissal Under Section 707*

**Section 707(a)**

(a) The court may dismiss a case under this chapter only after notice and a hearing and only *for cause, including—*

(1) unreasonable delay by the debtor that is prejudicial to creditors;

(2) nonpayment of any fees or charges required under chapter 123 of title 28; and

(2) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521(a), but only on a motion by the United States trustee.

- A debtor’s ability to repay debts may be considered. *Merritt v. Franklin Bank, N.A. (In re Merritt)*, No. 98-2399, 2000 U.S. App. LEXIS 6877 (6th Cir. Apr. 12, 2000).

- Other factors considered:

- (1) The debtor reduced his creditors to a single creditor in the months prior to filing the petition.

- (2) The debtor failed to make lifestyle adjustments or continued living an expansive or lavish lifestyle.

- (3) The debtor filed the case in response to a judgment pending litigation, or collection action; there is an intent to avoid a large single debt.

- (4) The debtor made no effort to repay his debts.

- (5) The unfairness of the use of Chapter 7.

- (6) The debtor has sufficient resources to pay his debts.

- (7) The debtor is paying debts to insiders.

- (8) The schedules inflate expenses to disguise financial well-being.

- (9) The debtor transferred assets.

- (10) The debtor is over-utilizing the protection of the Code to the unconscionable detriment of creditors.
- (11) The debtor employed a deliberate and persistent pattern of evading a single major creditor.
- (12) The debtor failed to make candid and full disclosure.
- (13) The debts are modest in relation to assets and income.
- (14) There are multiple bankruptcy filings or other procedural “gymnastics.”

*See, e.g., Rahim v. Pacifica Loan Four, LLC (In re Rahim)*, 449 B.R. 527, 533 (E.D. Mich. 2010).

### **Section 707(b)(1)**

Section 707(b)(1) provides that a Chapter 7 case involving a debtor with *primarily consumer debts* may be dismissed, or converted to a Chapter 11 or 13 case with the debtor’s consent, if “the granting of relief [under Chapter 7] would be an abuse of the provisions of this chapter.” 11 U.S.C. § 707(b)(1) (emphasis added). Whether “abuse” under Section 707(b)(1) exists is determined by the “means test” set forth in Section 707(b)(2) or under “bad faith” or “totality of circumstances” standards set forth in Section 707(b)(3). 11 U.S.C. § 707(b)(2) & (b)(3)(A)-(B).

#### *Does Means Test Apply?*

Although a split of authority exists, relying upon a plain reading of Section 707(b)(1), several courts hold that Section 707(b) does not apply to converted cases. *See, e.g., In re Thoemke*, 2014 Bankr. LEXIS 451, at \*5 (Bankr. M.D. Fla. 2014).

- Understanding nature of alleged claims against debtor is important; are they “primarily consumer?”
- Understanding what the means test would look like, if applied, also important.

### **Section 707(b)(3) – Totality of the Circumstances**

(3) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter in a case in which the presumption in paragraph (2)(A)(i) does not arise or is rebutted, the court shall consider—

(A) whether the debtor filed the petition in bad faith; or

(B) the totality of the circumstances (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor) of the debtor’s financial situation demonstrates abuse.



### 3. Potential “Reconversion”

#### **Section 706(b)**

“On request of a party in interest and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time.”

#### *Involuntary Servitude?*

Where an individual debtor is concerned, conversion from Chapter 7 to Chapter 11 is inappropriate because individuals cannot be forced into a repayment plan against their will. *See In re Graham*, 21 B.R. 235, 239 (Bankr. N.D. Iowa 1982) (denying creditor’s request to convert an individual Chapter 7 debtor’s case to Chapter 11 “[b]ecause the forced submission of the debtor to [a chapter 11] plan is the sole purpose of the Movant’s motion to convert these proceedings from Chapter 7 to Chapter 11 and because the effect of such an 11 U.S.C. § 706(b) conversion would be such a forced submission . . . .”); *see also In re Freunscht*, 53 B.R. 110, 112 (Bankr. D. Ver. 1985) (holding that individual debtors under Chapter 7 may not be compelled to submit to a repayment plan in Chapter 11) and *In re Brophy*, 49 B.R. 483, 484 (same). Despite the reasoning of cases like *Graham*, *Freunscht*, and *Brophy*, some courts have converted individual debtor cases under Section 706(b). *See, e.g., Schlehuber v. Fremont Nat’l Bank (In re Schlehuber)*, 489 B.R. 570 (B.A.P. 8th Cir. 2013).

Because Section 706(b) does not articulate grounds for conversion, however, it is widely recognized that such relief rests within the discretion of the court “based on what will most inure to the benefit of *all parties in interest*.” *Tex. Extrusion Corp. v. Lockheed Corp. (In re Tex. Extrusion Corp.)*, 844 F.2d 1142, 1161 (5th Cir. 1988) (emphasis added); *see also In re Modern Metal Prods. Co.*, 422 B.R. at 124; *In re Quinn*, 490 B.R. 607, 621 (Bankr. D. N.M. 2012); and *In re Lobera*, 454 B.R. 824, 853 (Bankr. D. N.M. 2011). The interests to be considered include the debtor’s. *Lobera*, 454 B.R. at 824 (denying creditors’ motion to convert Chapter 7 case in order to capture debtor’s postpetition income pursuant to Section 1115(a), an outcome that “would not further the interests of the Debtor or those that depend on him for support.”).

#### **V. Fees and Expenses – Getting Paid –**

- §327 and Bankruptcy Rule 2014 – Application to Employ.
- §330 and Bankruptcy Rule 2016.
- Know your debtor’s cash flow and budget – Back to Pre Filing Diligence.